

**Summary of Testimony of
Curt L. Hébert, Jr.
Chairman, Federal Energy Regulatory Commission
Before the Committee on Energy and Natural Resources
United States Senate
May 3, 2001**

Electricity markets in California and the Western United States face a substantial imbalance of supply and demand. While no one can build generating capacity fast enough to eliminate the imbalance this summer, the Commission is taking all appropriate action within its jurisdiction to help mitigate the problems in these markets. The Commission's actions center on three critical needs.

First, we must promote new supply and load reductions. Market prices are sending the right signals to both sellers and buyers (at least those not subject to a rate freeze). Market prices will increase supply and efficiency, promote delivery, enhance infrastructure and reduce demand, thus correcting the current imbalance. Last week, the Commission adopted a market monitoring and mitigation plan for California consistent with these principles. Among the provisions of that plan, the Commission adopted a price mitigation approach for real-time sales, in emergency hours, that will ensure that customers are adequately protected against unjust and unreasonable rates, while also providing a market-oriented price for California generators. California generators will be allowed to sell above that price if they can justify their costs. Other provisions of last week's order, applicable during all hours, improve the Commission's ability to detect and remedy anticompetitive bidding behavior by electricity suppliers in California. In addition, the Commission instituted an investigation into wholesale rates in Western states outside California, and is seeking comment on what other relief may be necessary.

Second, infrastructure improvements are greatly needed throughout the West and especially in California. We must create the appropriate financial incentives to ensure that the transmission system is upgraded and that new natural gas pipelines are built. The Commission has taken action on these issues recently, and is considering additional action.

Third, we need a regional transmission organization (RTO) for the West. A West-wide RTO will increase market efficiency and trading opportunities for buyers and sellers throughout the West. Last week, the Commission took major steps toward RTO formation in the West, approving an RTO (including an independent transmission company to own the transmission facilities of six utilities) spanning eight Western states and conditioning its California market monitoring and mitigation plan on the filing of an acceptable RTO proposal by California utilities. An RTO is an essential tool in improving transmission reliability and addressing the transmission bottlenecks contributing to the market dysfunctions in California and the West.

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I. Overview

Mr. Chairman and Members of the Committee:

Thank you for the opportunity to appear here today. Electricity markets in California and the Western United States face a substantial imbalance of supply and demand. While no one can build generating capacity fast enough to eliminate the imbalance this summer, the Commission is taking all appropriate action within its jurisdiction to help mitigate the problems in these markets. The Commission's actions center on three critical needs.

First, we need to encourage new supply and load reductions. Market prices are sending the right signals to both sellers and buyers (at least those not subject to a rate freeze). Market prices will increase supply and efficiency, promote delivery, enhance infrastructure and reduce demand, thus correcting the current imbalance. Last week, as described below, the Commission adopted a market monitoring and mitigation plan for California consistent with these principles. Among the provisions of that plan, the Commission adopted a price mitigation approach that will ensure for real-time sales, in emergency hours, that customers are adequately protected against unjust and unreasonable rates, while also providing a market-oriented price for California generators. California generators will be allowed to sell above that price if they can justify their costs. Other provisions of last week's order, applicable during all hours, improve the Commission's

ability to detect and remedy anticompetitive bidding behavior by electricity suppliers in California. The Commission also instituted an investigation into wholesale rates in Western states outside California, and is seeking comment on what other relief may be necessary.

Second, infrastructure improvements are greatly needed throughout the West and especially in California. We need to create the appropriate financial incentives to ensure that the transmission system is upgraded and that new natural gas pipelines are built. The Commission has taken action on these issues recently, and is considering additional action.

Finally, we need a regional transmission organization (RTO) for the West. California is not an island. It depends on generation from outside the State. The shortages and the prices in California have affected the supply and prices in the rest of the West. The Western transmission system is an integrated grid, and buyers and sellers need non-discriminatory access to all transmission facilities in the West. A West-wide RTO will increase market efficiency and trading opportunities for buyers and sellers throughout the West. As described below, the Commission took important steps last week to promote RTO formation in the West.

II. Market Monitoring and Mitigation

A. Action to Help California

In the past few months, the Commission has issued dozens of orders to address dysfunctional wholesale energy markets in California and the West. Last week, the Commission adopted an innovative plan, which packages together a number of related measures, for market monitoring and mitigation in California. San Diego Gas & Electric

Co. v. Sellers of Energy and Ancillary Service, et al., 95 FERC ¶ 61,115 (2001). This plan strikes an appropriate balance by bringing market-oriented price relief to the California electric market, providing greater price certainty to buyers and sellers of electric energy, promoting conservation, and - importantly - simultaneously encouraging investment in efficient generation and transmission.

The Commission established price mitigation for the real-time market run by the California Independent System Operator Corporation (ISO). However, the price mitigation, based on a price determined from a market-oriented formula, applies only when California reaches a Stage 1 emergency, i.e., when generating reserves are at or below 7.5 percent. (In all hours, as explained further below, the Commission remains vigilant in detecting and remedying anticompetitive bidding behavior by electricity suppliers.)

The price mitigation simulates the price a competitive market would produce. Under the price mitigation, a market-driven price for real-time electricity would be determined each day based on market costs for electricity inputs (natural gas and emission allowances), and the fuel usage ratio ("heat rate") and emission rate for the least efficient generator needed to meet demand that day. All California generators bidding at or below this market-driven price would be paid the market-driven price. Any California generator bidding above this market price and selected to run by the ISO would be paid its price, subject to cost justification and potential refunds, but its bid would not raise the market price. Non-California generators would be paid the market price or the bid price, but would not be subject to price justification or potential refunds.

The price mitigation would apply to marketers as well. A marketer could accept the market-driven price or specify its own price. If its price exceeds the market price, the marketer would be required to justify its price based on the amount it paid for power. However, marketers (and generators) are not allowed to include extra cost components for scarcity rents or opportunity costs.

This price mitigation plan reflects the way pricing works in competitive markets. As in a competitive market, the price is set by the highest priced supply needed to meet demand. The plan also provides certainty to the market. All bidders at or below the market price are paid the market price, and need not provide subsequent justification.

The plan provides incentives for investments in efficient generation. The market price under this plan is set by the price of the least efficient generating facility used each day. Any new facility will receive this same price. Thus, the more efficient the new facility is, the more it will earn. Conversely, the plan provides incentives for retiring or replacing inefficient, dirtier facilities.

The plan does not set price caps. A price cap is a fixed limit on sellers' prices that does not change over time, i.e., a snapshot. By contrast, the Commission's price mitigation allows prices to vary each day based on market changes in the cost of electricity inputs (fuel and emission allowances). Moreover, each generator can bid any amount it chooses, so long as the generator can justify any bid above the announced market price. For example, if a seller's own gas costs exceed the gas costs used in determining the market-driven price, the seller can seek to justify the higher costs.

Nor does the plan discourage the sale of generation into California from facilities located outside of California. Out-of-state facilities have no obligation to sell into California. If they do, they can recover any bid, even if in excess of the market-driven price, that is accepted by the ISO; they do not have to justify prices in excess of the market-driven price.

The price mitigation fulfills the requirements of the Federal Power Act. The Commission has broad discretion in setting rates, and is not required to use cost-based rates or any other specific methodology so long as the end result of its ratemaking is within a zone of reasonableness. The Commission's ratemaking can reflect non-cost factors such as the need to promote development of new supplies or transportation capacity or to increase market efficiency.

The plan contains several other important elements. For example, all jurisdictional sellers with "participating generator agreements" (PGAs) with the ISO must offer all power that is available in real-time and not already scheduled or committed by contract. This includes marketers who control generation that is subject to a PGA. In addition, all sellers that own or control generation in California, including non-public utilities, and sell in the ISO's markets or use the ISO's transmission facilities must do the same as a condition of being able to participate in ISO markets and also as a condition of using Commission jurisdictional transmission facilities. In addition, these sellers must agree to abide by the same price mitigation and monitoring that applies to the other generators. These conditions were put in place by the Commission so that all generators -- even those that are not

otherwise subject to the Commission's jurisdiction -- participate in helping to solve California's problems. The only exception to the "must-offer" requirement is for hydroelectric facilities because of their multi-purpose characteristics (e.g., irrigation, recreation and power production).

Also, all public utilities buying from the ISO must submit "demand bids" identifying the price they are willing to pay for power and the load to curtail if prices exceed that amount. This requirement will help the ISO's real-time market behave more like a competitive market, where increases in price reduce demand.

The plan enhances the ISO's ability to coordinate and control planned outages. The ISO must submit weekly reports to the Commission on outages and bid data, so that the Commission staff can continue to monitor the market. Further, the Commission modified the market-based rate authority of public utility sellers to prohibit anticompetitive bidding behavior in the ISO's real-time market.

All of the elements of the plan, with the exception of the price mitigation, operate 24 hours a day, seven days a week, during the specified duration of the plan. Any effort to engage in physical or economic withholding of scarce electric capacity, to the detriment of California consumers, will be met with a vigorous and appropriate remedy.

The various elements of the Commission's market monitoring and mitigation plan should be viewed, as they were intended by the Commission, as an integral package. The price mitigation cannot be evaluated in isolation. The other elements of the Commission's plan (outage coordination and monitoring, demand bids, the "must-offer" requirement and

the change in market-based rate authority to bar anticompetitive bidding behavior) are vital to the success of the price mitigation and the plan as a whole.

Finally, the Commission imposed two important limits on its plan. First, all of the mitigation terminates not later than one year from now, so that California cannot rely indefinitely on mitigation in lieu of new generation and conservation. Second, all mitigation is conditioned on the ISO and California's three investor-owned utilities filing an acceptable RTO proposal by June 1, 2001. An RTO is an essential tool in improving transmission reliability and addressing the transmission bottlenecks contributing to the market dysfunctions in California (and the West).

B. Investigation of Other Real-Time Western Sales

As part of the same order last week, the Commission opened a formal investigation into prices charged by public utilities for real-time wholesale power sales (i.e., up to 24 hours in advance) throughout the West (other than sales through the ISO). The Commission proposed: (1) to mitigate prices charged by all public utilities; and, (2) to impose mitigation as a condition on all non-public utilities using the interstate transmission facilities of public utilities. Similar to the Commission's approach for the ISO's market, price mitigation here would apply only when contingency reserves fall below 7.0 percent in any control area in the WSCC. The Commission sought comments on what the price mitigation for these sales should be, stating that its intent is to mirror its approach in the ISO's real-time market to the extent possible. The Commission also proposed, as it required in the ISO's market, that generators should have to offer all energy available in real-time. As above, hydroelectric

generation would be exempt from the "must-offer" requirement but not from the price mitigation rules.

After receiving and reviewing public comment on its proposal, the Commission will determine the market monitoring and mitigation plan for real-time wholesale sales in the West other than sales through the ISO.

III. Other Commission Efforts to Increase Supply and Reduce Demand

Six weeks ago, the Commission issued an order seeking to increase energy supplies and reduce energy demand in California and the West. Removing Obstacles to Increased Electric Generation and Natural Gas Supply in the Western United States, 94 FERC

¶ 61,272 (2001) ("Order Removing Obstacles"). The Commission implemented several measures immediately, including:

- o streamlining filing and notice requirements for various types of wholesale electric sales, including sales of on-site or backup generation and sales of demand reduction;
- o extending (through December 31, 2001) and broadening regulatory waivers for Qualifying Facilities under the Public Utility Regulatory Policies Act of 1978, enabling those facilities to generate more electricity;
- o expediting the certification of natural gas pipeline projects into California and the West; and,
- o urging all licensees to review their FERC-licensed hydroelectric projects in order to assess the potential for increased generating capacity.

The Commission also proposed, and sought comment on, other measures such as incentive rates and accelerated depreciation for new transmission facilities and natural gas pipeline facilities completed by specified dates, blanket certificates authorizing construction

of certain types of natural gas facilities, and greater operating flexibility at hydroelectric projects to increase generation while protecting environmental resources.

The Commission received many comments on these proposals. I expect the Commission to complete its review of these comments and finalize its actions on these issues soon. In addition, the Commission already is acting on many of the initiatives it announced in its Order Removing Obstacles. For example, in the month of April, the Commission significantly expedited its processing of applications - approved in a mere three or four weeks - to add significant amounts of natural gas pipeline capacity to California.

IV. A West-wide RTO

The development of a West-wide RTO is vital to preventing future problems in the West. Market conditions in California have affected markets throughout the West because the Western transmission system is an integrated grid. A West-wide RTO is critical to support a stable interstate electricity market that will provide buyers and sellers the needed non-discriminatory access to all transmission facilities in the West. A West-wide RTO will increase market efficiency and trading opportunities for buyers and sellers throughout the West.

Last week, the Commission took major steps toward RTO formation in the West. First, the Commission accepted key parts of a proposal for an RTO that will span eight Western states, RTO West. RTO West will operate (but not own) more than 90 percent of the high voltage transmission facilities from the U.S.-Canadian border to southern Nevada.

The Commission said RTO West can serve as a platform for the ultimate formation of a West-wide RTO.

In the same order, the Commission accepted a proposal for an independent transmission company within the RTO West structure, TransConnect. TransConnect will own and operate the transmission facilities of six utilities in the region.

Finally, as noted above, the Commission conditioned its price mitigation in the California ISO's real-time market on the ISO and California's three investor-owned utilities filing an RTO proposal by June 1, 2001, consistent with the characteristics and functions set forth in the Commission's Order No. 2000. As the Commission stated, this condition "recognizes that the only real solution to supply problems that affect the western United States is to create a regional response." By letter dated May 1, 2001, the Commission's General Counsel and the Director of the Commission's Office of Markets, Tariffs and Rates, wrote to the ISO and the three utilities, and offered to make the Commission's staff available to assist them in completing the application.

V. Conclusion

The Commission will continue to take steps that, consistent with its authority, can help to ease the present energy situation without jeopardizing longer-term supply solutions. As long as we keep moving toward competitive and regional markets, I am confident that the present energy problems, while serious, can be solved. I am also confident that market-based solutions offer the most efficient way to move beyond the problems confronting California and the West. Thank you.